STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

AQUA ILLINOIS, INC. and ILLINOIS-AMERICAN WATER COMPANY,	)	
Petition to Initiate a Rulemaking for Approval of Amendments to 83 Illinois Administrative Code Part 656, Qualifying Infrastructure Plant Surcharge.	)	Docket No. 15-0017

JOINT REPLY BRIEF ON EXCEPTIONS OF AQUA ILLINOIS, INC. AND ILLINOIS-AMERICAN WATER COMPANY

Dated: July 30, 2015

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I. Introduction

The current Part 656 Rules governing the QIP surcharge authorized by Section 9-220.2 of the Public Utilities Act have been in effect since 2001. Both Aqua Illinois, Inc. and Illinois-American Water Company have successfully operated QIP riders under those Rules for over 10 years. In light of the increasing need to invest in aging infrastructure, however, and with the benefit of 10 years of experience with the existing Rules, the two utilities filed a petition to initiate this rulemaking and broaden the Part 656 Rules to enhance their effectiveness. The utilities' proposed amendments were the result of their extended consultations over several months with Commission Staff. (*See* Ver. Pet. ¶ 10.) Those amendments—such as modification of the 5% QIP surcharge revenues cap and expansion of QIP-eligible facilities, which the Proposed Order adopts—did not change the basic architecture of the Part 656 Rules or their straightforward QIP surcharge mechanism.

However, intervening parties have proposed various other revisions to the Rules. Their three substantive proposals—an accumulated deferred income taxes (ADIT) adjustment, a reduction in return on equity (ROE) for utilities who implement a new QIP surcharge between rate cases, and an adjustment to recoverable QIP investment for accumulated depreciation on entire plant accounts (whether QIP investment or not)—all share common flaws. They all are contrary to the language of Section 9-220.2, and they all seek to reduce the amounts the utility can recover through the QIP surcharge, undermining the surcharge mechanism's very purpose. Although the utilities' original proposed revisions, about which the utilities consulted Staff, did not contain any of these adjustments, Staff now supports all three. But these three adjustments must not be adopted. To adopt any of them would result in Part 656 Rules that are a step backward; rather than encourage infrastructure investment, the revised Rules would discourage it, contrary to Section 9-220.2.

The Administrative Law Judge's Proposed First Notice Order correctly rejects the ROE and ADIT adjustments. The exceptions proposed by Staff and Intervenors on these adjustments should also be rejected, for the reasons discussed below. And for the reasons discussed in the utilities' brief on exceptions, the Proposed Order should be revised to also reject the accumulated depreciation adjustment—it is as inconsistent with Section 9-220.2 as the other two.

Staff and the Attorney General applaud the Proposed Order for its adeptness in resolving the complex contested issues in this rulemaking. (Staff BOE at 3 ("As to most issues raised in this proceeding, the ALJPO skillfully navigates the complexities of the issues . . . ."); AG BOE at 1 ("The People appreciate the Proposed First Notice Order's . . . careful consideration of the record data and the various parties' arguments.").) Yet those parties would change most of the Proposed Order's skillfully and carefully reasoned conclusions based on selective reliance on traditional ratemaking tenets; selective reliance on Section 9-220.2; selective reliance on the record of this proceeding; and selective reliance on the Commission's gas QIP surcharge rules, Part 556.

For example, Staff (and others) want to include an adjustment for ADIT in the straightforward QIP surcharge calculation because this is a "necessary tenet of ratemaking." (Staff BOE at 7.) But there are other "necessary tenet[s] of ratemaking" that would *increase* a utility's rate base—like cash working capital tied to QIP investment—that Staff inexplicably ignores. Staff doesn't explain why it cherry-picks ADIT. And, despite that Staff now thinks that ADIT is a "necessary tenet of ratemaking," the original proposed revisions to the Part 656 Rules, which followed several months of consultation between the utilities and Staff, did not include an ADIT adjustment. (*See* Ver. Pet. ¶¶ 10, 15.)

As another example, Staff and the AG argue that because the gas QIP surcharge rules adjust that surcharge for ADIT, the water and sewer rules should too. But the gas rules also include a higher cap on annual surcharge revenues than the water and sewer rules, and the gas rules don't include an excess earnings cap or reduce a utility's authorized ROE. This Staff and the AG conveniently overlook.

And, again, Staff and the Illinois Industrial Water Consumers (IIWC) continue to advocate an arbitrary 50 basis point reduction—via the Part 656 Rules—to the ROE that the Commission authorized in a utility's last rate case if the utility implements a new QIP surcharge rider between rate cases. Yet they overlook the record of this proceeding: namely, an indisputable absence of any demonstration of reduced business risk (even assuming there was any) related to the QIP surcharge, let alone to the extent of 50 basis points. Notably, although Aqua and IAWC have had QIP surcharges for over a decade, no party—Staff and IIWC included—has proposed a specific basis point reduction to the utilities' ROE on account of the QIP surcharge in their rate cases, the appropriate forum for complex cost of capital determinations. One wouldn't be justified anyway.

In selectively relying on the law and the record, Staff and Intervenors seem to want the Commission to implement traditional ratemaking principles and parts of the gas rules that *reduce* the costs recoverable by a utility under the straightforward water and sewer QIP surcharge, while ignoring principles and parts that *increase* recoverable costs. They ask the Commission to read into Section 9-220.2 adjustments that are not there. Rather than enhance the Part 656 Rules, this would complicate the Rules and make them something that Illinois water and sewer utilities wouldn't want to use. This, in turn, would *encourage* the frequency of the rate cases required to

recover the utilities' investment in the State's aging infrastructure—ultimately resulting in increased costs to the very customers that the Intervenors in this docket represent.

The result of this rulemaking should not be Part 656 Rules that are an unlawful departure from Section 9-220.2. That law plainly intends to encourage investment via an exception to complex traditional ratemaking—a straightforward surcharge. The Commission should adopt the Proposed Order, therefore, with the single substantive exception noted by Aqua and IAWC.

II. Argument

A. The Proposed Order correctly declines to inject ADIT—and all the related complexities—into the straightforward QIP surcharge mechanism.

The Proposed Order correctly concludes that the QIP surcharge should not include an ADIT adjustment: "the proposal to recognize ADIT balances would severely increase the complexity of calculating QIP balances in a manner that is not contemplated by Section 9-220.2 of the Act." (Proposed Order at 37.)

Staff, the AG, and IIWC take exception to this. Every argument that they advance in support of an ADIT adjustment, however, is selective and flawed. And many of their arguments are ones that the Proposed Order already considered—and correctly rejected.

1. Excluding ADIT from the Part 656 Rules won't overcharge customers.

Staff and the AG continue to argue that a utility's rate base must be reduced by ADIT because ADIT are customer-supplied funds. So, they argue, QIP investments should be likewise reduced by ADIT when the QIP surcharge is calculated. (Staff BOE at 4-6; AG BOE at 2-4.)

a. Traditional ratemaking principles don't apply to the QIP surcharge.

The flaw in Staff and the AG's argument is that traditional ratemaking principles simply don't apply to the QIP surcharge.

As the utilities explained, Section 9-220.2 of the Act, 220 ILCS 5/9-220.2, makes an exception to traditional ratemaking for recovery of QIP investment costs. (Utils. Init. Cmts. at 4.) IIWC also expressly agrees that "the QIP surcharge is intended to be an exception to rate base [sic] proceedings. In other words[,] traditional ratemaking concepts do not apply." (IIWC BOE at 3 (internal citation omitted).) The Commission has recognized this as well: the QIP surcharge is "essentially [an] exception[] to test-year ratemaking." *Ill.-Am. Water Co.*, Docket 11-0767, Order at 168 (Sept. 19, 2012). And this is something that the Commission must acknowledge in this rulemaking. *See, e.g.*, *Hadley v. Ill. Dep't of Corrs.*, 224 Ill. 2d 365, 385 (2007) ("Where an administrative rule conflicts with the statute under which it was adopted, the rule is invalid."). The Proposed Order aptly does so: "[t]he water and sewer QIP surcharge is intended to be an exception to base rate proceedings." (Proposed Order at 37.)

Staff and the AG, however, argue that traditional ratemaking concepts should nevertheless apply to the QIP surcharge and reconciliation; in short, that the annual reconciliation should have all the features of a rate case. But the annual reconciliation is not intended to have all the features of a rate case, as the statute makes clear when it provides that the surcharge be "independent of any other matters related to the utility's revenue requirement." 220 ILCS 5/9-220.2(a). And even if the annual reconciliation was intended to be a rate case every year, Staff and AG ignore those components of traditional ratemaking, like cash working capital, that would increase the QIP surcharge in favor of only those that decrease it.

Just because traditional ratemaking concepts—like ADIT adjustments—don't apply to the QIP surcharge, however, doesn't mean that the surcharge is unlawful or results in unreasonable rates. *Cf. People ex rel. Madigan v. Ill. Commerce Comm'n*, 2015 IL App (1st) 140275, ¶¶ 1, 16 (affirming Commission order and rejecting AG argument that it was necessary

to deduct ADIT from a revenue reconciliation balance before calculating interest on the balance to prevent excessive rates). The operation of the QIP surcharge mechanism is inherently fair and balanced. During the period between rate cases, the utility may benefit from the reduction in regulatory lag with QIP investment. But its customers will likewise benefit to the extent other costs associated with that investment—cash working capital, property taxes, investment capital taxes, and the like—increase, but are not included in the QIP surcharge calculation. The utility won't recover those costs from customers until its next rate case, when its rates are reset. (Utils. Reply Cmts. at 4.)

Staff's reliance on Section 9-211 of the Act highlights this point. (Staff BOE at 5.) That statute provides that "[t]he Commission, in any determination of rates or charges, shall include *in a utility's rate base* only the value of such investment which is both prudently incurred and used and useful in providing service to public utility customers." 220 ILCS 5/9-211 (emphasis added). As Staff further notes, in a traditional rate case, "[t]he measure of the amount of investment so dedicated must account for *both increases and* the decreases over a consistent period." (Staff BOE at 4 (emphasis added) (citation omitted).)

In determining the QIP surcharge, QIP investment costs aren't "include[d] in a utility's rate base." 220 ILCS 5/9-211. And, again, neither are cash working capital, property taxes, investment capital taxes, or the other costs that increase a utility's annual QIP investment. In fact, the QIP surcharge mechanism doesn't establish a utility's rate base at all. (If it did, it would be a traditional rate case.) Per the statute, the surcharge operates outside the revenue requirement. 220 ILCS 5/9-220.2(a). However, as explained, when QIP investment is added to the utility's rate base in its next rate case, the associated costs that increase and decrease the

value of that investment, including ADIT, will also be added. This is consistent with Section 9-211 *and* Section 9-220.2.

The utilities pointed out in comments that, due to the intended operation of the QIP surcharge mechanism, there are costs associated with their investment in QIP that they will not recover until their next rate case. (Utils. Reply Cmts. at 4, 13.) No party responded to that point. Staff and Intervenors only want recognize the decreases associated with QIP investment (namely ADIT); not any of the increases. This is too selective.

b. The Part 656 Rules' excess earnings test protects customers.

As the utilities explained and the Proposed Order recognizes, the existing Part 656 Rules contain a key consumer protection to ensure reasonable rates: the excess earnings test. (Utils. Reply Cmts. at 11-12.) (Note that Section 9-220.2 imposes no such limitation. 220 ILCS 5/9-220.2.)

Staff selectively passes over the excess earnings test in arguing that the QIP surcharge is inflated under the existing rules. (Staff BOE at 4-7.) The AG at least acknowledges the test, although it claims the test is inapplicable when it comes to ADIT. (AG BOE at 6.) Both approaches are wrong.

The excess earnings test in Section 656.80 of the Part 656 Rules should not be ignored. 83 Ill. Admin. Code § 656.80(a), (c), (d), (f)(4). As explained by the utilities, the test means that, regardless of its level of its QIP investment, a utility cannot recover any QIP surcharge revenues that cause it to over-earn its authorized rate of return on rate base. (Utils. Reply Cmts. at 11-12.) That rate base necessarily accounts for "both increases and decreases in investment over a consistent period"—the rate case test year—including ADIT, accumulated depreciation, and the other rate base components considered in a traditional rate case. (*Id*.) This ensures, then, that QIP surcharges are reasonable and fair.

The AG dismisses the excess earnings test, claiming that it doesn't matter in the ADIT context because it addresses ADIT on plant other than QIP investments. (AG BOE at 6.) This position is flawed for the same reason that any reliance on traditional ratemaking concepts is flawed in the QIP surcharge context. When the QIP surcharge mechanism establishes the recoverable annual QIP investment under the existing Rules' architecture, it doesn't pull in all costs—increases and decreases—associated with QIP investment. It's simply not intended to establish a full revenue requirement each year. *See Ill.-Am. Water Co.*, Docket 11-0767, Order at 168 (Sept. 19, 2012) (noting that the QIP surcharge is "essentially [an] exception[] to test-year ratemaking"); (Utils. Reply Cmts. at 4). So it doesn't "charg[e] too much in the QIP surcharge," as the AG inaccurately assumes. (AG BOE at 6, n.8.) And, again, the excess earnings test ensures that, whatever QIP investment is accounted for in a given year, total rates remain just as reasonable as those set in the utility's last rate case.

The Proposed Order already considered Staff and the AG's argument that the Part 656 Rules should include an ADIT adjustment so that customers aren't somehow overcharged. (Proposed Order at 36.) The Proposed Order correctly rejected that argument. (*Id*. at 37.)

The fact is, the existing Part 656 Rules never included an ADIT adjustment. And even the AG agrees that those Rules accomplish the purpose of the QIP surcharge. (Utils. Reply Cmts., Ex. B (IAWC/AQUA-AG 1.02).) So, there is no need to "correct" the Rules to incorporate an ADIT adjustment, as the AG complains (AG BOE at 3-4), and Staff and Intervenors offer no lawful reason why the Rules should include an ADIT adjustment now.

2. ADIT's complexity has no place in the Part 656 Rules.

As the utilities explained in comments, Section 9-220.2 is straightforward. (Utils. Reply Cmts. at 1, 4.) It authorizes a surcharge that allows water and sewer utilities to recover costs associated with their annual QIP investment "independent of any other matters related to the

utility's revenue requirement." 220 ILCS 5/9-220.2(a)-(b). It requires annual reconciliations. 220 ILCS 5/9-220.2(c). Consistent with this, the Commission's existing Part 656 Rules establish a straightforward QIP surcharge mechanism that is reconciled annually. 83 Ill. Admin. Code, Part 656.

The utilities also explained extensively that, as other regulatory commissions have found, ADIT, and all their complexities, have no place in the straightforward water and sewer QIP surcharge mechanism. (Utils. Reply Cmts. at 5-11 (citing dockets).) This is particularly true here, given that the Illinois water and sewer QIP surcharge, per Section 9-220.2, can function prospectively and, again, must be regularly reconciled. 220 ILCS 5/9-220.2(b)-(c).

So the Proposed Order correctly rejects Staff and Intervenors' ADIT adjustment on this ground: "the proposal to recognize ADIT balances would severely increase the complexity of calculating QIP balances in a manner that is not contemplated by Section 9-220.2 of the Act." (Proposed Order at 37.)

On exceptions, Staff, the AG, and IIWC try to get around ADIT's complexity a number of ways. But they can't.

a. Staff and the AG can't escape ADIT's history of complex rate case litigation.

Staff suggests in its brief on exceptions that the utilities alone think ADIT are complex. (*See, e.g.*, Staff BOE at 4, 5 (stating that the "utilities might find that valuation complex or difficult" and that it is "alleged by the utilities to be burdensome, difficult, or complex").) But Staff itself has agreed with the Proposed Order and the utilities on this point in other proceedings. *See, e.g.*, *Commonwealth Edison Co*., Docket 12-0321, Order at 17 (Dec. 19, 2012) (finding that Staff did not endorse an intervenor proposal to calculate ADIT on the expensed

portion of an accrued cost because Staff "claim[ed] that ADIT is a complicated issue which requires careful analysis").

The AG, for its part, is no doubt well aware of the litigious nature of ADIT calculations, both before the Commission and the Appellate Court, given the AG's recent rate case experience. (*See* Utils. Reply Cmts. at 6-7 (citing dockets).) Despite this, the AG suggests that ADIT issues aren't "'too complicated'" because an ADIT adjustment in IAWC's last rate case was relatively small, and Aqua accepted an ADIT adjustment in its rate case. (AG BOE at 4.) That's a non-sequitur. The AG is confusing dollars with complexity. Whether an ADIT adjustment is relatively small or is one that the utility chooses to accept does not mean that the ADIT calculation wasn't complex or didn't garner extensive litigation. And that the AG points to ADIT adjustments proposed in two of the utilities' last three rate cases simply highlights that ADIT is a litigious subject.

b. Staff and Intervenors can't resolve the complications that will result from adding ADIT to the QIP surcharge.

Despite suggesting that ADIT aren't all that complex, Staff and Intervenors offer little to resolve any of the complex ADIT issues in the water and sewer QIP surcharge context that the utilities raised in their reply comments. (Utils. Reply Cmts. at 7-10.)

For example, the utilities explained that a utility's net operating loss carry-forward for tax purposes is calculated on a company-wide (or, in a consolidated tax return context, on a group-wide) basis. (*Id*. at 9.) How much of a net operating loss carry-forward is attributable to a utility's projected and actual QIP investment, which represents only a small portion of its plant, therefore, is not apparent. (*Id*.) The complexity associated with bifurcating the net operating loss carry-forward between QIP expenditures and the rest of the utility's operations is absent from a traditional rate case because a base rate case looks at utility-wide investment and tax.

See, e.g., 83. Ill. Admin. Code § 285.2080 (Schedule B-9). But, if ADIT were injected in the QIP surcharge mechanism, this complex bifurcation not only would be necessary, but also would be required to be projected and reconciled *every year*. (Utils. Reply Cmts. at 9-10.) Staff and Intervenors do not explain how this would or could be done, let alone explain why the task wouldn't be unduly complex.

Instead, the AG summarily concludes that because "it is clearly *possible* to estimate ADIT for a projected future period," ADIT isn't too complex. (AG BOE at 5 (emphasis added).) But the AG acknowledges, as it must, that such complex projections are typically done only when the utility choses to file a rate case. (*Id.* at 5; Utils. Reply Cmts. at 8.) And the test year rate base is not later subject to reconciliation, like the QIP surcharge is.

Surprisingly, the AG thinks that the reconciliation feature of the Part 656 Rules itself somehow alleviates the complexities of ADIT in the QIP surcharge context. (AG BOE at 5-6 (arguing "[t]o the extent that audit [sic] changes occur over the year the AIP [sic] charge is in effect, the reconciliation process can address the change").) Staff concurs. (Staff BOE at 6 (claiming that "the reconciliation effectively renders moot any difference between the prospective and historical operation of the QIP Surcharge").)

It is the annual reconciliation feature, however, coupled with the utilities' prospectively-operating QIP surcharge, that will potentially *increase* the complexity of ADIT in the water and sewer QIP surcharge context. (Utils. Reply Cmts. at 7-10.) As the utilities explained in comments, projecting and then reconciling ADIT tied to specific QIP on an annual basis creates a host of complications not contemplated by Section 9-220.2 and the straightforward QIP surcharge mechanism. (*Id*.)

For example, as the utilities explained, the calculation of ADIT depends on many moving parts, including the current state of the tax law (which changes frequently); the tax deductions currently available to the utility; the utility's current tax position (for example, whether it has net operating losses); and, depending on the corporate structure, the parent company's current tax position. (*Id*. at 5.) Due to the seasonal nature of water and sewer utility revenues and the various tax deductions available, however, a utility's actual tax status and elections may vary from what is forecasted, and cannot be known until after the end of the tax year and may not be known until after a QIP surcharge reconciliation filing in March. (*Id.* at 8); *see* 83 Ill. Admin. Code § 656.80(a). Further, tax laws may change after the filing of a prospective QIP surcharge reconciliation, just as authorization of 2014 bonus depreciation did in late December 2014. (Utils. Reply Cmts. at 8.) All this makes forecasting, and later reconciling, a utility's tax position difficult, especially on an annual basis. (*Id.* at 8.) Neither Staff nor the AG respond to this point.

Consider, for example, Dockets 14-0224/0225, North Shore Gas Company and Peoples Gas Light & Coke Company's 2014 rate case. After the conclusion of hearing and briefing in that case, the AG made a filing asking that the utilities be directed to quantify the effect of the extension of 50% bonus depreciation through 2014 (not passed until December 19, 2014) on their 2015 test-year ADIT balances, rate bases, and revenue requirements, and that the effect be reflected in rates. *North Shore Gas Co., Peoples Gas Light & Coke Co.*, Dockets 14-0224/0225 (Cons.), AG Ver. Reply to Resp. of Utils. to ALJ's Ruling of Dec. 15, 2014, 2-3 (filed Jan. 5. 2015). The AG argued that the availability of 50% bonus depreciation in 2014 had the potential to increase the actual 2015 test-year balances of ADIT, and thus reduce the utilities' test year rate bases and revenue requirements. (*Id*. at 2.) The AG noted, however, that "the actual revenue

requirement effects are dependent on numerous factors such as the timing of plant additions, the extent to which property qualifies, and the extent to which the bonus depreciation results in net operating losses ('NOLs')." (*Id.*) IAWC and Aqua question whether injecting ADIT into the Part 656 Rules would prompt similar, after-the-fact requests and complexities in their annual QIP filings where the utilities' tax positions would necessarily have to be projected—and reconciled—every year to account for ADIT.

Moreover, the prospective operation of the water and sewer QIP surcharge sets Illinois water and sewer utilities apart from gas utilities operating under the Part 556 Rules for the gas QIP surcharge rider. The gas surcharge does not operate prospectively. And annual reconciliations under the gas rules will always look backward to a historical level of QIP. 220 ILCS 5/9-220.2(e)(2) ("For each calendar year in which a surcharge tariff is in effect, the natural gas utility shall file a petition with the Commission to initiate hearings to reconcile amounts billed under each surcharge authorized pursuant to this Section with the actual prudently incurred costs recoverable under this tariff in the preceding year."); 83 Ill. Admin. Code § 556.60 ("Determination of the QIP Surcharge Percentage"). Water and sewer utilities that use a prospectively-operating QIP surcharge as provided by Section 9-220.2, however, will always be projecting, and then reconciling, their QIP investment—every year. 220 ILCS 5/9-220.2(c); 83 Ill. Admin. Code § 656.40(b)(1) ("Determination of the Qualifying Infrastructure Plant Surcharge Percentage") (annual prospective operation).

Still, Staff claims "[t]here is no evidence that the gas utilities subject to the Gas QIP Rule have found such requirement to be unduly burdensome, exceedingly complex, or difficult to calculate." (Staff BOE at 6.) In fact, there is *no* evidence in this proceeding about the gas utilities' experience at all. Regardless, it's clear from the record of the Part 556 rulemaking that

the utilities *did* have significant concerns related to ADIT, namely tax normalization rules and the extraordinary consequences when those rules are violated. *Ill. Commerce Comm'n on Its Own Mtn.*, Docket 13-0548, Second Notice Order at 2-3 (Oct. 23, 2013). Aqua and IAWC have also raised normalization concerns in this docket, which no responding party has addressed. (Utils. Reply Cmts. at 8-9.)

Staff takes it one step further. Staff claims, "[m]ore telling, there is no proceeding before the Commission seeking revision of the Gas QIP Rule to remove ADIT from consideration in calculating QIP." (Staff BOE at 6.) In other words, Staff believes that the absence of a pending gas QIP rules revision means it is appropriate to insert ADIT into the water and sewer QIP surcharge rules. Here, Staff tells an incomplete story.

As the Commission is aware, the gas QIP rules are very new. They were effective December 27, 2013. 38 Ill. Reg. 1998. And the very first reconciliation proceeding under the rules has only recently been filed—Docket 15-0209 was initiated on March 20, 2015. *See generally Peoples Gas Light & Coke Co.*, Docket 15-0209, Petition (March 20, 2015). A review of that docket shows that no party has even responded to the utilities' petition, let alone raised any issues, including ADIT. For this reason, the AG's conclusion that "ADIT has also specifically proven to be a workable mechanism for calculating QIP surcharges for gas infrastructure investment" also goes too far. (AG BOE at 5.) Whatever happens with the gas surcharge rules remains to be seen.

IIWC at least recognizes that calculating ADIT is complex. Rather than passing ADIT off as simple, IIWC summarily concludes that "[t]he Commission will simplify the utilities [sic] ADIT accounting for the QIP [surcharge] and direct the utilities to reflect changes in ADIT by tracking incremental differences between the book depreciation and tax depreciation on the

qualifying investments only." (IIWC BOE at 6.) Yet, IIWC doesn't explain how this would be accomplished, other than to note it thinks that "[o]ther ADIT changes need not be reflected in the QIP rate base and revenue requirement." (*Id*.) To ignore "other ADIT changes," such as those attributable to a net operating loss carry-forward, however, would improperly value ADIT. (Utils. Reply Cmts. at 7-10.) So, IIWC's vague solution is not a solution at all.

c. Staff and the AG cannot avoid Section 9-220.2's simplicity.

What water and sewer utilities do in their rate cases, or what gas utilities do for the gas QIP surcharge, and whether that means water and sewer utilities can do it here, doesn't matter. Here, Section 9-220.2 controls, and Section 9-220.2 is simple. When it suits Staff, Staff agrees. (Staff BOE at 8 (stating, in advocating an arbitrary ROE reduction, "[a]s the Joint Petitioners' note, Section 9-220.2 of the Act truly is simple . . . ."). *See also* IIWC BOE at 7 ("As the Joint Petitioners agree, Section 9-220.2 is simple.").)

With respect to ADIT, however, Staff and the AG overlook the simplicity of Section 9-220.2. Staff argues that the "[c]omplexity or the difficulty of a calculation is not a legal basis upon which the Commission should reject" it. (Staff BOE at 4-5.) But where, as here, the simplicity of the QIP surcharge is rooted in the *law*, any position that its complexity is legally meaningless is false. *See Hadley*, 224 Ill. 2d at 385 ("Where an administrative rule conflicts with the statute under which it was adopted, the rule is invalid."). And, as the Appellate Court recently found, the Commission cannot add ADIT terms to a non-traditional rate mechanism where the statute doesn't include them. *People ex rel. Madigan v. Ill. Commerce Comm'n*, 2015 IL App (1st) 140275, ¶¶ 33-34, 44 (affirming Commission finding that an ADIT adjustment should not be read into the Energy Infrastructure Modernization Act where the legislature did not clearly intend one: "Certainly petitioners have not sustained their burden to identify anything in

the language of subsection (d)(1) or its legislative history that compels a finding that ADIT *must* be deducted from a reconciliation balance prior to the calculation of interest.").

The AG similarly asserts that "[g]iven the legal importance of considering ADIT, Joint Petitioners' argument that ADIT would overly complicate QIP calculations is smoke." (AG BOE at 6.) It is not. Again, Section 9-220.2 intends an exception to complex ratemaking—a straightforward surcharge mechanism. *Ill.-Am. Water Co.*, Docket 11-0767, Order at 168 (Sept. 19, 2012) (noting the QIP surcharge is "essentially [an] exception[] to test-year ratemaking."). Complexity is counter to that intent, and therefore would be unlawful. *See, e.g.*, *Columbia Gas of Pennsylvania, Inc.*, PA PUC, Docket P-2012-2338282, Order at 36 (May 22, 2014), 2014 Pa. PUC LEXIS 553 ("ADIT is a dynamic element that is constantly changing based on available tax deductions, the mix of plant in service, and the Company's current tax position, and such changes cannot be accurately captured in the straightforward formula used to calculate the DSIC [distribution system improvement charge]. . . . [W]e believe that the inclusion of an ADIT adjustment would involve a level of analysis and complexity that goes beyond the scope of what is required by Act 11 with regard to the calculation of the DSIC.").

3. Selective reliance on the gas QIP surcharge rules doesn't justify imposition of an ADIT adjustment here.

As they did in comments, Staff and the AG continue to point to the Part 556 Rules in support of their position that the Part 656 Rules should also adjust for ADIT. (Staff BOE at 6; AG BOE at 5-6.) Here, they are especially selective. They advocate only some aspects of the gas QIP surcharge rules—namely ADIT—but ignore several key distinctions between those rules and the water and sewer rules.

Most importantly, the Part 556 Rules do not include an excess earnings test. That is, as explained, a water and sewer utility must credit to customers any QIP surcharge revenues that

cause the utility to exceed its authorized rate of return on rate base. 83 Ill. Admin. Code § 656.80. A gas utility need not. *See generally* 220 ILCS 5/9-220.3; 83 Ill. Admin. Code, Part 556. As the utilities have explained, the excess earnings test in the water and sewer rules accounts for ADIT (and myriad other traditional rate base adjustments), and thus already ensures that the water and sewer QIP surcharge is reasonable. (Utils. Reply Cmts. at 11-12.)

Next, the Part 556 Rules (and their enabling statute) allow a gas utility to increase its QIP surcharge revenues annually at an average rate of 4%. 83 Ill. Admin. Code § 556.30(a); 220 ILCS 5/9-220.3(g). The existing Part 656 Rules, in contrast, cap water and sewer QIP surcharge revenues at 5%, 83 Ill. Admin. Code § 656.30(a), and the Proposed Order adopts a relatively modest revision—an annual average increase of 2.5%. (Proposed Order at 17.) Again, the law governing the water and sewer QIP surcharge, Section 9-220.2, does not impose a cap *at all*. 220 ILCS 5/9-220.2.

The Part 556 Rules also don't require an adjustment to the utility's authorized return on equity. *See* 220 ILCS 5/9-220.3(f) ("The rate of return applied shall be the overall rate of return authorized by the Commission in the utility's last gas rate case."). But, again, this is a distinction that Staff and the AG conveniently overlook. (*See infra* § II.B.)

Put simply, the gas QIP surcharge rules do not support an ADIT adjustment here. (Utils. Reply Cmts. at 13.)

The Proposed Order has already considered Staff and Intervenors' selective arguments that the Part 656 Rules should be the same as the Part 556 Rules (in this respect) anyway. (Proposed Order at 36, 37 (finding "[t]he AG notes that unlike the gas infrastructure rider rule, the Part 656 Rules do not adjust the QIP balance by ADIT" and "Staff believes this amendment is also consistent with the requirements of the Gas QIP Rule, 83 Ill. Adm. Code 556.60(b)").)

The Proposed Order correctly rejected those arguments. (*Id.* at 37.) Staff and the AG offer nothing new that could change the Proposed Order's concededly carefully and skillfully reasoned conclusion.

B. The Proposed Order correctly declines to arbitrarily reduce a utility's authorized return on equity via the Part 656 Rules.

The Proposed Order correctly rejects IIWC's proposal to reduce—via the Part 656 Rules—a water and sewer utility's authorized ROE by an arbitrary 50 basis points when a QIP surcharge is introduced between rate cases. (Proposed Order at 38.) In so doing, it aptly recognizes an absence of "any evidence . . . showing that the QIP surcharge actually reduces a utility's risk profile, and even if it does, to what extent," as well as any "evidence demonstrating that a 50 basis point reduction would be appropriate for calculating the appropriate return on QIP investment." (*Id*.)

Staff and IIWC take exception. But their exceptions mischaracterize the record and attempt to give weight to "evidence" that is nothing more than conclusory statements.

1. Staff's exceptions on the ROE adjustment mischaracterize the issue as "uncontested."

Staff attempts to present the ROE adjustment issue as one that is not contested. This mischaracterizes the record.

Staff claims that "uncontested attestations" in its comments and Intervenors' that the QIP surcharge "does, in fact, reduce a utility's risk profile" (Staff BOE at 8), suffice as "evidence . . . *showing* that the QIP surcharge *actually* reduces a utility's risk profile" (Proposed Order at 38 (emphasis added)). They do not. These "attestations" are merely conclusory statements, unsupported by calculation or analysis. As discussed below, conclusory statements are not the same thing as an actual "showing" of something.

And the absence of an opposite conclusory "attestation"—that the QIP surcharge does not reduce risk—is not evidence that the utilities agree. Here again, Staff mischaracterizes the record, asserting that "even the Joint Petitioners did not deny that a QIP surcharge reduces a utility's risk profile." (Staff BOE at 8.) In reply comments, the utilities explained not only that IIWC had not supported its risk reduction adjustment, but also that IIWC *could not* support such an adjustment. (Util. Reply. Cmts. at 14.) In other words, that there is no risk reduction to adjust for.

This is confirmed by Staff's own arguments in the next paragraph of its brief on exceptions, where Staff argues that 50 basis points is the right adjustment because the utilities offer no alternative estimate. (Staff BOE at 8.) The utilities offer no alternative adjustment because no adjustment is appropriate, consistent with their position that a QIP surcharge does not reduce a utility's risk profile. And this is not just the utilities' position, but the Commission's as well: in not a single rate case since Aqua and IAWC first sought authorization for a QIP surcharge (2001 for Aqua, 2004 for IAWC), has the Commission ever adopted a specific risk adjustment for the QIP surcharge rider (and in fact no party ever proposed one). *See generally*, *Consumers Ill. Water Co.*, Docket 03-0403, Order at 24-44 (April 13, 2004); *Aqua Ill. Co.*, Docket 04-0442, Order at 42-46 (April 20, 2005); *Aqua Ill. Co.*, Dockets 05-0071/0072 (cons.), Order at 51-54 (Nov. 8, 2005); *Aqua Ill. Co.*, Docket 06-0285, Order at 7-12 (Dec. 20, 2006); *Ill.-Am. Water Co.*, Docket 07-0507, Order at 55-93 (July 30, 2008); *Aqua Ill. Co.*, Dockets 07-0620/07-0621/08-0067, Order (Nov. 13, 2008); *Ill.-Am. Water Co.*, Docket 09-0319, Order at 89-113 (April 13, 2010); *Aqua Ill. Co.*, Docket 10-0194, Order at 15-22 (Dec. 2, 2010); *Aqua Ill. Co.*, Docket 11-0436, Order at 11-39 (Feb. 16, 2012); *Ill.-Am. Water Co.*, Docket 11-0767, Order at 80-112 (Sept. 19, 2012); *Aqua Ill. Co.*, Docket 14-0419, Order at 27-49 (March 25, 2015).

The utilities pointed out in comments that neither Staff nor Intervenors provided any support for their ROE adjustment. (Utils. Reply. Cmts. at 14.) Staff appears to believe that making unsupported "attestations" somehow places the burden on the utilities to develop an analysis refuting it. It does not. The utilities vehemently opposed a ROE reduction on any level in their reply comments. (*Id*. at 14-16.) They explained that such a reduction is unlawful given Section 9-220.2's plain language and is unnecessary given the existing Part 656 Rules' excess earnings test. (*Id*.) So Staff takes too much liberty with the record here.

2. The record does not support any ROE reduction, let alone a 50 basis point one.

Neither Staff nor Intervenors provided any study or analysis to support a ROE risk adjustment, much less a 50 basis point one. Neither Staff nor Intervenors explain why such an adjustment is appropriate, given that, as indicated, the Commission has never adopted one for IAWC or Aqua.

Yet Staff thinks there is "evidence" in this proceeding that supports a ROE adjustment because Staff and Intervenors made conclusory statements to that effect. (Staff BOE at 8 ("aver[ring]" that Staff and Intervenors' "attestations constitute evidence" and "not[ing] that three parties submitted verified comments *attesting* that a 50 basis point adjustment is reasonable") (emphasis added).) But this is not the case. Conclusory "attestations" about reduced risk aren't tantamount to actual showings of it. *See Universal Telecom Review*, Docket 95-0170, 1997 Ill. PUC LEXIS 132, *11 (Mar. 12, 1997) (rejecting as unpersuasive evidence presented in the form of unsupported conclusory statements); *Ameren Ill. Co.*, Docket 13-0301, Order at 46 (Dec. 9, 2013) (same).

Staff asserts that its "attestations" (and others') that 50 basis points is the right amount suffice as "evidence *demonstrating* that a 50 basis point reduction would be appropriate" as

opposed to some other amount. (Staff BOE at 8; Proposed Order at 38 (emphasis added).) Here, again, Staff confuses conclusory statements with actual demonstrations. There is simply no record evidence that *any* basis point reduction is appropriate, let alone 50 basis points.[1] Staff summarily states that a 50 basis point reduction "is the only *supported* position in the record." (Staff BOE at 9 (emphasis added).) But, in fact, the Proposed Order is correct: the only "supported" position is no adjustment. (Proposed Order at 38.)

Cost of capital determinations are complex, and typically warrant significant litigation in a rate case. Multiple cost of capital witnesses evaluate the utility's risk under a number of models. *See, e.g.*, *Ill.-Am. Water Co.*, Docket 11-0767, Order at 80-113 (Sept. 19. 2012) (summarizing multiple parties' cost of common equity analyses and recommendations and the Commission's conclusions). That has not happened here. Absent any analysis, Staff and IIWC's reductions are simply arbitrary, and the Commission cannot adopt them. *See Bus. & Prof'l People for the Pub. Interest v. Ill. Commerce Comm'n*, 136 Ill. 2d 192, 230-34 (1989) (the Court disfavors arbitrary assumptions in the rate proceeding context as "considerations clearly . . . not findings based on the record.").

And, as discussed, where ROE analyses *have* happened—in IAWC and Aqua's rate cases—no party, Staff and IIWC included, has proposed a specific basis point adjustment related to IAWC or Aqua's QIP surcharge. *See supra* § B.I (citing dockets). The Commission certainly

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[1] Compare, for example, Docket 07-0241/0242, where the Commission initially approved Peoples Gas and North Shore Gas's Rider Volume Balancing Adjustment (VBA), which decoupled the utilities' revenues from their sales. *Peoples Gas Light & Coke Co./North Shore Gas Co.* Dockets 07-0241/0242 (Cons.), Order (Feb. 5, 2008). There, after evaluating ROE analyses by multiple witnesses, the Commission concluded that a 10 basis point ROE reduction was appropriate to reflect reduced operating risk that resulted from the rider. (*Id.* at 99.) Here, without *any* risk analysis, let alone the comprehensive cost of capital analyses attendant to a rate case, Staff and IIWC would impose a reduction *five times greater*. That is nonsensical.

has not adopted one. (*Id*.) Given this, and the utilities' position against *any* ROE reduction, it is rational that the utilities would not propose an alternate reduction.

Staff nevertheless concludes that, because the utilities did not offer any number in response to IIWC's arbitrary 50 basis point reduction, the number shouldn't be zero. (Staff BOE at 8.) Staff's selective view of the record cannot be given credence. The utilities' opposition to this adjustment, and their rate case history, clearly supports that the number should indeed be zero.[2]

3. IIWC's exceptions appear to misunderstand its own proposal.

In exceptions, IIWC states that the "PO errs in its finding that the record does not support a reduction to the Joint Petitioner's ROE." (IIWC BOE at 7.) But IIWC's proposal was to reduce the authorized ROE by 50 basis points when a QIP surcharge is introduced between rate cases. (*See, e.g.*, AG Reply Cmts. at 10 ("Mr. Gorman later clarified in a data request response dated May 20, 2015 and labeled RWB-IIWC 1.04 that this adjustment would only apply if the QIP surcharge was not in effect during the prior rate case.").) Since Aqua and IAWC already have QIP riders in effect, the adjustment would not apply to them. So it is incorrect to refer to any reduction to "Joint Petitioner's" ROE.

4. Complex cost of capital determinations belong in a rate case.

Again, complex cost of capital determinations are more appropriately made in a rate case, where multiple cost of capital experts analyze a particular utility's financial and operating risks

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[2] Staff also contends that "to authorize an ROE that does not reflect that risk reduction would be unlawful." (Staff BOE at 2.) The Part 656 Rules, however, have never included a return on equity reduction. *See generally* 83 Ill. Admin. Code, Part 656. To the extent Staff's position, then, is that the existing Rules are unlawful, or that every water and sewer QIP surcharge reconciliation order made under the Rules is unlawful, or that every Aqua and IAWC rate case order is unlawful, because, as explained, none have imposed a specific basis point reduction related to the utilities' QIP surcharge riders, Staff's position cannot be fairly considered. *See Peoples Gas Light & Coke Co. v. Buckles,* 24 Ill. 2d 520, 528 (1962) (orders of the Commission that are within its jurisdiction are not subject to collateral attack).

relative to the current market and the utility's industry peers. Cost of capital determinations are not "one size fits all" sorts of determinations, and they have no place in rules applicable to multiple utilities or rules the purpose of which is to simply authorize a statutory surcharge rider.

Therefore, IIWC's suggestion that, if the Commission wants *actual evidence* on this issue, it should initiate an investigation, is misplaced. (IIWC BOE at 8 (emphasis added).) Again, the appropriate adjustment is zero. But if the Commission disagrees, this can be evaluated where cost of capital determinations are already appropriately evaluated—in an individual utility's rate case.

C. The Proposed Order correctly modifies the current 5% cap on QIP investment cost recovery to a 2.5% annual average increase.

The Proposed Order agrees that modifying the existing 5% cap on QIP cost recovery to an annual average 2.5% increase "should result in more gradual rate increases to ratepayers, and reduce the risk of shock present under the existing rules." (Proposed Order at 17.) The Proposed Order concludes the modification is "both reasonable and necessary to the future operations of water utilities in Illinois to ensure necessary upgrades are made." (*Id.*) Staff concurs. (Staff Reply Cmts. at 3.)

The AG does not dispute that investment in Illinois' aging water and sewer is necessary to provide adequate water and sewer services to Illinois residents. (Utils. Reply Cmts., Ex. E (IAWC/AQUA-AG 1.04).) And the AG, IIWC, and RFHWR, as consumer advocates, certainly cannot fairly dispute that gradual rate increases are preferable to rate shock. Yet those parties all take exception to the Proposed Order in this regard. (AG BOE at 7-11; IIWC BOE at 2-4; RFHWR BOE at 1.)

Their exceptions should be rejected. Their arguments that the cap modification is not justified are based on a selective view of the record. Their arguments that there should be *more*

rate cases are misplaced. And the Proposed Order already considered, and dismissed, their arguments against a modified QIP surcharge cap.

1. Intervenors dismiss the record evidence supporting modification.

The AG, IIWC, and RFHWR argue that the utilities have not provided evidence of their growing investment needs to justify modifying the existing 5% annual on QIP surcharge revenues. (AG BOE at 7-9; IIWC BOE at 2-4; RFHWR BOE at 1.) The Proposed Order, however, correctly rejects that concern. It bases its conclusion modifying the QIP surcharge cap on "the evidence presented in this proceeding," including "the increasing level of necessary investment in Illinois water and sewer infrastructure that the Joint Petitioners have shown they must make in future years." (Proposed Order at 17.)

As the Proposed Order concludes, the record is ample:

- Aqua and IAWC have provided service to Illinois customers since the late 1800s—for over 125 and 139 years, respectively. (Ver. Pet. ¶ 3; Utils. Init. Cmts. at 3.)

- Consequently, much of the utilities' infrastructure is old. It must be continuously replaced so that the utilities can continue to provide their customers adequate, efficient, reliable, and least cost utility service. (Ver. Pet. ¶ 3; Utils. Init. Cmts. at 3.)

- The investment need is not limited to Aqua and IAWC—it is a national problem, as reported by the United States Environmental Protection Agency in April 2013. The need in Illinois is specifically $19.0 *billion*, and has increased from $5.3 billion the decade prior. This means that Illinois is behind only California, Texas, and New York in terms of greatest water infrastructure investment need. (Ver. Pet. ¶ 3; Utils. Init. Cmts. 2-3.)

- Aqua has identified over $200 million of necessary pipe replacements in its Kankakee and Vermillion service areas alone. (Utils. Reply Cmts. at 20.) In its Kankakee division, for example, Aqua has identified 112 miles (23% of the system; 12% of the State) of aged pipe that needs replaced. In its Vermillion division, the utility has identified 120 miles (40% of the system; 13% of the State) of aged pipe that needs replaced. (Utils. Reply Cmts. at 20.)

- In its Kankakee and Vermillion service areas, however, Aqua has met the existing Rules' 5% cap every year but one for the past five. Aqua estimates that it will take more than 50 years to remedy its aging infrastructure investment needs in those areas using the existing

(unexpanded) Part 656 Rules' annual QIP surcharge. (Ver. Pet. ¶ 3; Utils. Init. Cmts. at 6.; Utils. Reply Cmts. at 20.)

- IAWC spent more than $47 million in 2014 just to keep pace with the needs of its aging distribution infrastructure. (Ver. Pet. ¶ 3; Utils. Init. Cmts. at 6.)

- IAWC had over $4.25 million of replacement investment in 2014 not recovered through its QIP surcharge riders. (Utils. Init. Cmts. at 7.)

- Aqua had nearly $11.5 million of replacement investment in 2013 not recovered through its QIP surcharge riders. (*Id*. at 7.)

- Moreover, replacement project costs have increased by as much as 75% over the decade since the existing Part 656 Rules were enacted in 2001. (*Id*. at 6-7.)

- The cost of replacement is increasing because municipalities and government agencies, such as the Illinois Department of Transportation, are heightening their restoration requirements. (Util. Ver. Pet. ¶ 9; Utils. Init. Cmts. at 3, 6-7.)

- For example, the utilities were once required to restore pavement at a standard of one foot wider than the trench for replacement main, or typically 5-6 feet total. Now, they are required by many communities to resurface the entire pavement width, typically 30 feet or more. (Utils. Init. Cmts. at 6-7.)

- Where the utilities could once replace a main for $100 per foot, main replacements today typically cost $176 per foot of main replaced. (*Id*. at 6-7.)

Again, the record is ample. Intervenors, however, approach the record with inexplicable selectivity. The AG and RFHWR, for example, claim that the utilities have not demonstrated the need in Illinois, specifically, or their share of that need. (AG BOE at 8; RFHWR BOE at 2.) But the record does provide this information. The latest estimate of investment needed for Illinois is $19 billion. (Utils. Init. Cmts. at 2.) As the largest investor-owned utilities in the State, Aqua and IAWC bear a significant portion of the State's growing investment need. Further, the 232 miles of aged main that Aqua has identified for replacement in its Kankakee and Vermillion service areas alone make-up approximately 25% of the utility's main infrastructure. (*Id*. at 20.)

That the record doesn't satisfy the AG, IIWC, or RFHWR doesn't mean that it isn't sufficient or that the Proposed Order's conclusions are wrong.

2. The AG's accusations of impropriety are unsupported and unfair; and they certainly aren't evidence against the modification.

The AG argues that water and sewer utilities have or will manage their QIP programs imprudently. The AG alleges in its brief on exceptions that "[i]n light of the problems the Commission has faced with accelerated spending allowed under the Section 9-220.3 natural gas infrastructure investment rider, the Commission should be wary of creating another 'blank check' encouraging utilities to increase rates by up to 3.5% in a given year (and up to 2.5% on average annually) without meaningful safeguards in place to assure that the spending is well-managed and prudent." (AG BOE at 8; *see also id.* at 10 (improperly suggesting that the increase in investment won't be "prudently managed") and 12 (referring to the alleged "difficulties facing the gas infrastructure project").)

This accusation is unsupported and inappropriate. The utilities have managed their QIP surcharge programs properly over the more than 10 years since their inception. At no time has any party or the Commission ever suggested any impropriety in that operation. Certainly, the AG points to no examples of problems or Commission concerns. Put simply, there is no basis here, in any of the utilities' QIP surcharge reconciliation proceedings since they initiated their programs more than a decade ago, or in any rate case or other proceeding, for allegations of any improper conduct on the part of Aqua and IAWC in investing in their aging infrastructure.

The AG's accusation is also misplaced. The Part 656 Rules *do* include "meaningful safeguards . . . to assure that spending is well-managed and prudent." (AG BOE at 8.) As the Commission has already found, "Section 9-220.2 protects ratepayers by requiring a reconciliation process where recoveries are limited to 'prudently incurred costs.'" *Ill.-Am. Water Co.*, Docket 11-0767, Order at 168 (Sept. 19, 2012). In fact, both Section 9-220.2 and the Part 656 Rules require the Commission to review actual QIP investments for prudency in annual QIP

surcharge reconciliations. 220 ILCS 5/9-220.2(c); 83 Ill. Admin. Code §§ 656.80(a), (b), (h)(5). So the investment will not escape review. (Utils. Reply Cmts. at 22.) Thus the AG's belief that "[t]he close scrutiny provided to the enhanced gas infrastructure programs is totally absent from the proposal in this docket" (AG BOE at 8, n.10) is off-base.

The AG appears to be trying to tar the utilities with unspecified concerns about mismanagement of gas utility infrastructure investment programs. Such unsubstantiated allegations have no place in a Commission proceeding, and should be ignored.

3. Intervenors' advocacy of *more* rate cases confirms that the utilities' proposal will reduce rate case frequency.

The AG, IIWC, and RFHWR also oppose modification of the existing cap because it may extend the time between rate cases. (AG BOE at 9-10; IIWC BOE at 2-4; RFHWR BOE at 2.) Their position is flawed for many reasons.

First, to the extent they argue that there should be *more* rate cases, they appear to concede that a modified QIP surcharge cap will reduce rate case frequency. (*See, e.g.*, IIWC BOE at 3 (agreeing that "[e]limination of the 5% cap will reduce the frequency of rate cases . . . ").) That Intervenors seem to think this is a bad thing is puzzling. This is a benefit. Reducing rate case frequency reduces the attendant costs to customers, and recovery of QIP surcharges through a more stable, consistent, and gradual annual average 2.5% QIP surcharge reduces the "rate shock" to customers that would otherwise occur if QIP investment cost recovery was delayed until a utility's next rate case. (Ver. Pet. ¶ 11.a; Utils. Init. Cmts. at 4, 6, 9; Utils. Reply Cmts. at 20.)

Second, to the extent Intervenors argue that rate cases provide more oversight (*see, e.g.*, RFHWR BOE at 2 (arguing that "only through a periodic full rate case can ratepayers be protected from inappropriate charges")), they overlook that the existing Part 656 Rules, per Section 9-220.2, already contain opportunity for Commission review. Again, both Section 9-

220.2 and the Part 656 Rules require the Commission to review actual QIP investments for prudency in annual QIP surcharge reconciliations. 220 ILCS 5/9-220.2(c); 83 Ill. Admin. Code §§ 656.80(a), (b), (h)(5); (Utils. Reply Cmts. at 22). So "regulation or oversight" will not be "compromised," as Intervenors believe. (RFHWR BOE at 3.)

Next, to the extent Intervenors' opposition to recovery of costs outside of the traditional rate case context suggests a dissatisfaction with the concept of a water and sewer infrastructure rider generally, their discontent is misplaced given the statute. Intervenors continue to repeatedly advocate for "comprehensive rate case review" (AG BOE at 9; RFHWR BOE at 2; *see also* IIWC BOE at 5), suggesting that recovery of QIP investment costs through the QIP surcharge mechanism somehow "limit[s] the protection offered to utility customers by traditional ratemaking concepts." (IIWC BOE at 3; *see also see, e.g.*, RFHWR BOE at 2 (complaining that the "proposal seeks to . . guarantee payment of costs without a full rate case").) Whether the QIP surcharge rider is appropriate, however, is not at issue; that question was resolved by the legislature when it enacted Section 9-220.2 and simplified QIP investment cost recovery. *See, e.g.*, *Ill.-Am. Water Co.*, Docket 09-0251, Order at 9 (Mar. 16, 2010) (rejecting AG arguments against the utility's use of the QIP surcharge rider, noting "the concept of a QIP Rider was codified by the Illinois General Assembly and made a part of the Public Utilities Act as Section 9-220.2.").

Finally, notably, Section 9-220.2 sets *no* cap on annual QIP investment cost recovery. 220 ILCS 5/9-220.2. Thus, whether IIWC and the AG think that the Part 656 Rules *should* include a limit to the amount of QIP investment costs recoverable without complete, traditional rate case review (AG BOE at 10; IIWC BOE at 2) is beside the point. The legislature did not. This, too, Intervenors simply overlook.

4. The AG appears to agree that an increased QIP surcharge cap is necessary.

The AG appears to recognize that an increased cap in some form is necessary to allow water and sewer utilities to better meet the State's increasing investment needs. The AG points to a recently proposed 10% cap on the QIP surcharge (the distribution system investment charge, or DSIC) in Indiana. (AG BOE at 9.) The relevance of the AG's cite isn't clear. But the AG's approving reference to a 10% cap (a proposal not made by any party here) suggests a recognition that a higher annual cap is needed. At the very least, the reference to Indiana highlights that other States have recognized that more than a 5% QIP surcharge revenue cap is necessary to ensure continued investment in the nation's aged water and sewer infrastructure.

5. The Proposed Order already considered—and correctly rejected—Intervenors' selective and misplaced arguments.

IIWC offers a handful of other arguments in taking exception to the Proposed Order's finding approving a modified QIP surcharge cap. None of IIWC's arguments are new: IIWC or other parties already raised them, and the Proposed Order already rejected each of them. So none provide any basis to change the Proposed Order's reasoned conclusion.

For example, although IIWC did not file any reply comments, IIWC now responds to the AG's argument that, because IAWC's annual historical total utility plant investments "appear to be within a predictable range," this means modification of the QIP surcharge cap isn't necessary. (IIWC BOE at 3 (citing AG Init. Cmts. at 6).) The utilities already explained why this misses the point—total plant isn't the issue here; the issue is QIP. (Utils. Reply Cmts. at 20.) And the Proposed Order already acknowledged, and rejected, the AG's argument. (Proposed Order at 16.)

IIWC also now responds to the AG's argument in comments that modification of the 5% QIP surcharge cap "could generate sharp acceleration in utility rates." (IIWC BOE at 4 (citing

AG Init. Cmts. at 7).) Again, the utilities explained why the opposite is true: modification of the cap would foster gradual, more consistent, more predictable rate increases while promoting reduced rate case frequency. Without the modification, customers would be subject to the same cost recovery associated with needed infrastructure investment, albeit at a faster, higher rate and with the costs attendant to rate cases. (Utils. Init. Cmts. at 8-9; Utils. Reply Cmts. at 18-19.) And, again, the Proposed Order already acknowledged, and rejected, the AG's argument. (Proposed Order at 16.)

IIWC also argues, as it did in comments, that "cost decreases, or sales growth . . . will mitigate the price changes needed to provide the utility with full recognition of its cost of service." (IIWC BOE at 2.) Apart from ignoring that the QIP mechanism is an exception to traditional ratemaking (as IIWC itself admits (IIWC BOE at 3)), and so is not meant to establish a utility's cost of service, this also ignores that QIP, by definition, is non-revenue producing. 220 ILCS 5/9-220.2(b). It also ignores the Commission's findings in IAWC's last rate cases that "residential sales volume, on a per customer basis, has been declining and can reasonably be expected to continue to decline in the short term." *Ill.-Am. Water Co.*, Docket 11-0767, Order at 46 (Sept. 19, 2012). So there's no support for IIWC's alleged "sales growth," and the Proposed Order correctly dismissed that argument. (Proposed Order at 16.)

The Proposed Order also already acknowledged, and rejected, "IIWC's argu[ment] there should be a limit to the amount of surcharge that utilities can impose on customers without a complete rate case review of all revenue and cost of service elements for the utilities." (*Id*. at 17; IIWC BOE at 2.) Repeating these points won't make them true. Intervenors simply offer nothing new to change the Proposed Order's reasoned conclusion.

D. The Proposed Order correctly expands the type of plant eligible as QIP, consistent with the plain language of Section 9-220.2.

The Proposed Order recognizes that the existing Part 656 Rules are more restrictive than Section 9-220.2 in defining the types of plant that can qualify as QIP. (Proposed Order at 24.) The statute defines QIP as "plant items or facilities (including, *but not limited to*, replacement mains, meters, services, and hydrants) . . . ." 220 ILCS 5/9-220(b) (emphasis added). The Part 656 Rules, however, limit QIP to just the enumerated plant. 83 Ill. Admin. Code § 656.40(b)-(c). So the Proposed Order correctly finds that the QIP eligible accounts can and should be expanded—consistent with Section 9-220.2—to allow increased flexibility of QIP investment. (Proposed Order at 24, 23.) Staff concurs. (Staff Reply Cmts. at 3-5.)

The AG and RFHWR take exception. But their arguments ignore the statutory language and are one-sided.

First, the AG continues to ignore the plain statutory text, focusing only on the QIP eligible accounts in the existing Part 656 Rules. (AG BOE at 11-12.)

Next, the AG argues, as it did in comments, that this will expand the function of the QIP surcharge "without sufficient justification and oversight." (AG BOE at 11-12.) RFHWR reiterates a similar concern, and asks that the accounts not be expanded if the surcharge cap is modified. (RFHWR BOE at 2, 3.) This ignores the record and the law.

The justification for the expansion is clear: the utilities have other "non-revenue producing," non-rate base aged infrastructure, such as pumping equipment, that requires investment and that is as critical to serving Illinois customers as are "mains, meters, services, and hydrants." 220 ILCS 5/9-220.2(b); (Utils. Init. Cmts. at 9-11; Utils. Reply Cmts. at 21-22). Expanding the eligible QIP accounts under the Rules will simply allow the utilities to determine

where the greatest investment needs lie and approach their QIP investment with flexibility. (Utils. Init. Cmts. at 9-11; Utils. Reply Cmts. at 21-22.)

And there will continue to be oversight. Again, the Commission has already found that "Section 9-220.2 protects ratepayers by requiring a reconciliation process where recoveries are limited to 'prudently incurred costs.'" *Ill.-Am. Water Co.*, Docket 11-0767, Order at 168 (Sept. 19, 2012). QIP investment will continue to be subject to the annual prudency reviews consistent with Section 9-220.2 and the existing Part 656 Rules. 220 ILCS 5/9-220.2(c). Moreover, as the record reflects, the annual level of QIP surcharge will be capped (as it has always been), regardless of the accounts in which QIP is recorded. (Proposed Order at 23.)

The AG does not so much as acknowledge these points, let alone respond to them. Regardless, the Proposed Order already considered—and rejected—the AG's arguments here. (*Id.* at 23 (summarizing the AG's concerns in concluding to expand the eligible QIP accounts).) It correctly found "that there is sufficient protection in the proposed rule to prevent providing incentives for replacement over repair. The Commission also notes that this expanding of eligible QIP would not impact the total level of QIP recovery in a given year as the annual QIP increase remains capped." (*Id.* at 24.) The AG offers nothing new to change the Proposed Order's conclusions on this point.

E. Response to Staff and IIWC's Technical Corrections

1. Staff's third "Technical Correction" is wrong.

Staff states that "no amendments have been proposed to Section 656.40(d)." (Staff BOE at 12.) That's not correct. The utilities proposed the following amendment to existing Section 656.40(d), which Staff supported and the Proposed Order adopts:

> ~~d~~c) In addition to replacements, the following items may be classified as QIP: water main lining and related rehabilitation projects to eliminate water loss from water

> main breaks as well as main extensions ~~recorded in Account 331.~~ for water utilities that are constructed to eliminate dead ends and the unreimbursed costs recorded in the appropriate accounts listed in subsection~~s~~ (b) ~~and (c)~~ that are associated with relocations of mains, services, hydrants, and sewers occasioned by street or highway construction.

(Proposed Order, Appx. at 4-5 (amending Section 656.40(d); Ver. Pet ¶ 11.b, Ex. A at 4 (Section 656.40(d)).) So this "technical correction" should not be adopted.

2. IIWC mischaracterizes its own accumulated depreciation offset proposal.

IIWC attempts to clarify its own accumulated depreciation offset proposal, which the Proposed Order adopted in part (and which the utilities, in their BOE, explained should be rejected). (Proposed Order at 38.) Specifically, IIWC says that "it should be made clear the revision reflects all the incremental buildup of accumulated depreciation related to depreciation expense recoveries by the utilities in both QIP surcharges *and* in base rates, related to the *plant accounts* that are subject to recovery in a QIP surcharge." (IIWC BOE at 8-9 (emphasis added).)

This is not the proposal that IIWC made in this case. As IIWC clarified in discovery, its accumulated depreciation offset would adjust the level of annual QIP investment recoverable through the QIP surcharge for incremental accumulated depreciation on specific QIP, but not on total QIP-eligible *accounts*. (Utils. BOE at 18 & Attach B (IIWC response to RWB-IIWC 1.01, Attach. RWB-IIWC 1.01 at 2 (modifying Section 656.60(b)(1)) (served May 20, 2015)).)

Regardless, for all the reasons explained in the utilities' brief on exceptions, no accumulated depreciation offset should be added to the Part 656 Rules, and the Proposed Order should be revised in that lone substantive respect. (Utils BOE at 3-18.) So IIWC's (confused) clarification is moot.

III. Conclusion

The need for investment in Illinois' aging water and sewer infrastructure is substantial. And the need is growing. The utilities' ability to recover the costs of that investment under the existing Part 656 Rules, however, is restricted; the Rules are becoming investment-prohibitive. The Commission should therefore revisit the more-than-a-decade-old Part 656 Rules and broaden them in a manner contemplated by Section 9-220.2 that enables water and sewer utilities to better bear the State's infrastructure investment needs. The Proposed Order is nearly there: it correctly modifies the annual cap on QIP surcharge revenues to an annual average increase of 2.5% and expands the accounts eligible for QIP treatment under the Rules.

While the Part 656 Rules should be so expanded to address expanding investment needs, they should not be rewritten to incorporate adjustments that run counter to their purpose or the statute that authorizes them. The Rules should be revised to encourage, not discourage investment. As the utilities explained in their brief on exceptions, the outcome of this rulemaking should be optimal Part 656 Rules. And the best Part 656 Rules are rules that not only lawfully align with Section 9-220.2, but also encourage Illinois water and sewer utilities to use them.

The Staff and Intervenors' proposed adjustments for ADIT, ROE, and accumulated depreciation offset would do the opposite—they operate as a disincentive to investment. That is, if the Rules simply recalculate a utility's full revenue requirement each year, they will conflict with Section 9-220.2, defeat their purpose, and offer little incentive to water and sewer utilities to use the QIP surcharge, rather than traditional rate cases, to recover their cost to invest in the State's aging water and sewer infrastructure, despite the increasing investment need.

The Commission, therefore, should issue a First Notice Order and amended Part 656 Rules in this proceeding that align with Section 9-220.2 and ensure that the Part 656 Rules

continue to serve their intended purpose. The Commission should adopt the proposed amended Part 656 Rules attached as Attachment A to the utilities' brief on exceptions. These revisions will result in the best Part 656 Rules.

Dated: July 30, 2015

Respectfully submitted,

AQUA ILLINOIS, INC. and ILLINOIS-AMERICAN WATER COMPANY,

By: */s/ Anne M. Zehr*

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CERTIFICATE OF SERVICE

I, Anne M. Zehr, an attorney, certify that on July 30, 2015, I caused a copy of the foregoing *Joint Reply Brief on Exceptions of Aqua Illinois, Inc. and Illinois-American Water Company* to be served by electronic mail to the individuals on the Commission's Service List for Docket 15-0017.

/s/ Anne M. Zehr
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Illinois-American Water Company